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No. 379

In the Supreme Court of the United States

OCTOBER TERM, 1935

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAN JOAQUIN FRUIT & INVESTMENT COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 253–279) is reported in 28 B. T. A. 395. The opinion of the Circuit Court of Appeals (R. 338–344) is reported in 77 F. (2d) 723.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 20, 1935. (R. 344.) Petition for certiorari was filed August 19, 1935, and was granted October 14, 1935. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A lease of real estate with option to purchase was given prior to March 1, 1913, and the option was exercised after March 1, 1913. Was the property acquired, within the meaning of the Revenue Acts relating to gain or loss, when the option to purchase was given, or when the option was exercised and the property transferred?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 229:

BASIS FOR DETERMINING GAIN OR LOSS

SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property;

* * * * * *

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

* * * * * *

Revenue Act of 1924, c. 234, 43 Stat. 253, 258:

BASIS FOR DETERMINING GAIN OR LOSS, DEPLETION, AND DEPRECIATION

SEC. 204. (a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(*b*) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property * * * or (B) the fair market value of such property as of March 1, 1913, whichever is greater. * * *.

Revenue Act of 1926, c. 27, 44 Stat. 9, 14:

Section 204 (a) and (b) of the Revenue Act of 1926, so far as material, is identical with the quoted provisions of the Revenue Act of 1924.

Revenue Act of 1928, c. 852, 45 Stat. 791, 818:

Section 113 (a) and (b) of the Revenue Act of 1928, so far as material, is identical with Section 204 (a) and (b) of the Revenue Act of 1926.

STATEMENT

The facts, as found by the Board of Tax Appeals in its opinion (R. 253–279), may be summarized as follows:

On October 13, 1906, the Irvine Company leased to the San Joaquin Fruit Company 1,000 acres of bare land in Orange County, California, for ten

years beginning December 1, 1906. By the terms of the lease, the lessee was required to plant fruit trees on the land and develop a water supply therefor; the lessor was to receive as rent one-fourth of the crops produced on the leased premises. The lessee was given an option to purchase at $200 per acre, not in excess of 500 acres of the land before the expiration date of the lease, or to purchase at the expiration of the lease all of the 1,000 acres at the same price per acre. An exercise of the right to purchase portions of the tract during the life of the lease worked a termination of the option to purchase all of the tract on the expiration of the term of the lease. The lessee could not assign or transfer the lease, or sublet any portion of the land, without the written consent of the lessor. The lessee developed the land as required, and on November 30, 1916, exercised the option given in the lease to purchase the 1,000 acres, and at that time the consideration was paid and the deeds delivered. (R. 261–262.)

In 1922, the San Joaquin Fruit Company was reorganized as the San Joaquin Fruit and Investment Company, the respondent, and all of the property was transferred to it. (R. 262–264; 273–274.)

During the years 1922 and 1924 to 1928, respondent sold various tracts of the property. (R. 260.)[1]

[1] As stated by the court below, a determination of the basis for computing gain on sales will also establish the basis for 1920 to 1922, inclusive, and 1924 to 1928, inclusive. (R. 344, 255 260.)

depreciation on walnut and orange trees during the years

In considering respondent's tax liability for all the years, the Commissioner determined that the property was acquired on November 30, 1916, when the option was exercised and the property purchased, and that the cost was the $200,000 paid at that time for the land, plus the amounts paid for improvements under the lease agreement, and that this cost figure was the basis for ascertaining gain or loss (R. 264, 132, 174.) The Commissioner's cost figure was not disputed. (R. 275.)

The Board of Tax Appeals approved the Commissioner's determination. (R. 268.) The Circuit Court of Appeals reversed the decision of the Board (R. 344), holding that the property was acquired in 1906 when the option was given, and that therefore the basis for determining gain or loss was the March 1, 1913, value of the property.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the property was acquired when the option was given, and not when the property was paid for and the title transferred.

2. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The statutes provide that the basis for determining gain or loss on a sale of property shall be the cost thereof if *acquired* after February 28, 1913, and if *acquired* prior to March 1, 1913, the basis is the value of the property on that date. Here the

property sold by the taxpayer during the taxable years was purchased in 1916 upon the exercise of an option obtained in 1906. The taxpayer in 1906 leased the property for ten years, with an option to purchase at the end of the term, and made substantial improvements thereto.

Inasmuch as the option was not exercised until 1916, the taxpayer then, for the first time, became the owner of the property and on that date the taxpayer *acquired* the property. Prior to the exercise of the option the taxpayer had no estate or interest, legal or equitable, in the property other than as lessee. The option vested no estate in the taxpayer, but was a mere right to buy should it so elect. There is here no foundation for relating the title and estate acquired upon exercise of the option back to the date of the option. The doctrine of relation back is invoked only to protect the rights of the optionee against intervening rights acquired with notice of the option.

Treatment of the gain actually received by the taxpayer as income to it does not result in imposing tax on gains accrued to this taxpayer prior to March 1, 1913. There is no question here of the constitutional power of Congress to tax gains accruing prior to March 1, 1913, and taxation of the actual gain here realized does not contravene the intent of Congress to exclude from income gains accruing prior to March 1, 1913. Any gain which may have accrued on this property prior to March 1, 1913, did not accrue to this taxpayer as

it was not its property then or at any time prior to 1916. The gain resulting from increased value of property is income when realized to the actual recipient thereof whether or not the increase occurred entirely while the property was held by the particular taxpayer. The mere fact that the taxpayer was in the fortunate position of making large profits on sales of the property in no wise justifies exempting any portion of the gain from taxation, through the medium of treating the property as acquired at the date of the option and thereby increasing the basis contrary to the provisions of the statutes.

The decision below is erroneous and should be reversed.

ARGUMENT

Each of the applicable Revenue Acts (1921 to 1928), so far as here material, provides in substance that the basis for determining the gain from the sale or other disposition of property shall be the cost thereof if *acquired* after February 28, 1913, and shall be the cost or March 1, 1913, value thereof, whichever is greater, if *acquired* prior to March 1, 1913. Here there is no dispute as to the amounts received from the sales of property during the taxable years, nor is the actual amount paid for the property by the taxpayer in dispute. We are concerned only with the proper *basis* under the statutes upon which to determine the taxable gain derived. Thus the only question here involved is whether the property was *acquired* be-

fore or after March 1, 1913. The Commissioner contends that the property was not acquired by this taxpayer until 1916, when the option to buy was exercised and that prior to that time the taxpayer had no ownership, estate or interest in the property in question (except its estate as lessee), but only an option to purchase or a mere *right to acquire* the property.[2] The Circuit Court of Appeals, however, held that the taxpayer (R. 344)—

> "acquired" the land within the meaning of the income tax laws as of the time the option was given, and that the taxable gain resulting from subsequent sales of a portion of the land should be determined by deducting from the selling price the value as of March 1, 1913 of the land sold.

In so holding, we submit, the Circuit Court of Appeals clearly erred.

The distinguishing characteristic of an option contract is that it imposes no binding obligation upon the person holding the option, and such a

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[2] The respondent is the successor to the San Joaquin Fruit Company, which secured the option, and that company was reorganized in 1922 under the name of the respondent. All the property of the predecessor corporation was transferred to the respondent. It is now settled that the respondent is liable, as transferee, for any unpaid taxes due from its predecessor (52 F. (2d) 123) and that the property having been received by the respondent in a nontaxable transaction, the basis for determining the gain or loss from sales by the respondent is the same as it would have been in the hands of its predecessor (R. 339). Accordingly, for the purposes of this case we refer to the respondent and its predecessor generally as the "taxpayer."

contract is not to be confused with an agreement of sale binding upon both parties thereto and conferring mutual rights and interests in the property the subject of the agreement. An option is nothing more than a contract by which the owner of property agrees that another shall have *a right to buy the property at a stipulated price and upon agreed terms,* usually within a stated time. It has been recognized by the weight of authority for many years that an option to purchase property, whether it be a covenant in a lease of realty or a separate contract, does not convey and vest in the optionee any estate, title or interest, legal or equitable, in the property, and that this is a necessary consequence of the nature of the contract. The optionor does not sell the property but merely sells the right to buy if the optionee so chooses. *Willard* v. *Tayloe,* 8 Wall. 557, 564; *Richardson* v. *Hardwick,* 106 U. S. 252, 254; *Phenix Ins. Co.* v. *Kerr,* 129 Fed. 723 (C. C. A. 8th); *Todd* v. *Citizens' Gas Co. of Indianapolis,* 46 F. (2d) 855, 866 (C. C. A. 7th), certiorari denied, 283 U. S. 852; *Kadish* v. *Lyon,* 229 Ill. 35, 40, 82 N. E. 194; *Luigart* v. *Lexington Turf Club,* 130 Ky. 473, 480, 113 S. W. 814; *Gamble* v. *Garlock,* 116 Minn. 59, 133 N. W. 175; *Trumbull* v. *Bombard,* 171 App. Div. 700, 157 N. Y. S. 794; *Caldwell* v. *Frazier,* 65 Kan. 24, 68 Pac. 1076; *Bras* v. *Sheffield,* 49 Kan. 702, 710, 31 Pac. 306. The principle is recognized and applied in California as well as in other jurisdictions. *Smith* v. *Bangham,* 156 Cal. 359, 104 Pac. 689; *Hicks* v. *Christeson,* 174 Cal. 712, 164 Pac.

395; *Ludy* v. *Zumwalt,* 85 Cal. App. 119, 259 Pac. 52; *Menzel* v. *Primm,* 6 Cal. App. 204, 91 Pac. 754. See also, James on Option Contracts, Sec. 501 *et seq.*

In *Willard* v. *Tayloe, supra,* the lessees of real estate for a term of ten years, with an option to purchase, exercised the option and specific performance was decreed. Upon exercise of the option there arose a binding *contract of sale,* whereas prior thereto the lessee-optionee had only a *right to buy.* The Court said (p. 564):

> The covenant in the lease giving the right or option to purchase the premises was in the nature of a *continuing offer to sell.* * * * *When accepted* * * * *a contract of sale* between the parties was completed. (Italics supplied.)

Richardson v. *Hardwick, supra,* involved an option to purchase a half interest in lands, which was not exercised within the time specified. This Court said (p. 254):

> The written contract gives him [the optionee] the privilege, or, as counsel call it, an "option", to become equally interested in the lands by paying one-half the purchase-money, &c., within two years after its date. *The contract, of itself, did not vest him with any interest or estate in the lands. It merely pointed out the mode in which he might acquire an interest,* namely, by paying a certain sum of money within a certain time." (Italics supplied.)

In *Phenix Ins. Co.* v. *Kerr, supra,* an action to recover under a policy of insurance upon property as to which there had been given a lease with an option to purchase, it was held that the optionor was the unconditional owner of the property and entitled to the insurance proceeds. The court said (p. 727):

> And while the owner of the option may accept it, and compel the owner of the property to comply with its terms, until the owner of the option does so he has no interest in the property. He has nothing but a mere right to acquire an interest, and this is neither the ownership nor any interest in the property which impinges upon its unconditional ownership by him who gave the option.

In *Todd* v. *Citizens' Gas Co. of Indianapolis, supra,* it was said (p. 866):

> By the great weight of authority, a mere option to purchase land does not vest the holder of an option with any interest, legal or equitable, in the land.

And the principle is the same whether the option be a separate contract or contained in a lease. The mere fact that a lessee is in possession of real estate under a lease with an option to purchase, which is a covenant running with the land, and has made improvements upon the leased premises, does not vest in him under the option any estate or interest in the land. Any estate which he holds is merely the leasehold interest under the lease. In *Kadish*

v. *Lyon, supra,* the contention that a lessee, with an option to purchase, who had made improvements upon the premises, was in equity the owner of the fee, was rejected. The court said (p. 40):

> We think this [the contention] ignores the distinction between a contract for the purchase of real estate and a contract by which the owner gives to another the option to purchase lands. Kadish [the lessee] and those who succeeded him would acquire no interest in the land by virtue of this contract for an option until he or they had exercised their right to purchase. * * * The provision that the agreement to sell should be a covenant running with the land does not alter the situation.

In *Bras* v. *Skeffield, supra,* the lessee of property for a five year term, with an option to purchase, had entered into possession and cultivated the land. It was held that the contract for an option was not a sale and did not vest in the optionee any title or interest beyond what was acquired under the lease. *Caldwell* v. *Frazier, supra,* was an action of ejectment by the lessor against lessees who had taken possession of the property there involved under a lease, with an option to purchase. The lease having expired and the buildings having been destroyed by fire, the lessees had sought to exercise the option claiming that the property should be restored to its original condition or that the insurance proceeds should be applied to the agreed purchase price. The court said in answer to the

lessees' prayer for either specific performance of the contract or damages for its breach (pp. 27, 28):

> This court is of the opinion that under the facts a specific performance could not be decreed, and that plaintiffs in error [optionees] were not entitled to recover damages as for a breach of contract.
>
> *An option contract conveys no estate or interest in the property. It is but a continuing offer to sell, which may be accepted by the holder thereof, prior to a time usually fixed in the contract, and,* like other contracts *when accepted, takes effect from the date of its acceptance and not from the date of the offer.*
>
> * * * in an option contract to purchase the obligee takes no interest, the contract is incompleted, it lacks mutuality until acceptance, *and when accepted it does not relate back to the date of the offer,* * * *. (Italics supplied.)

To the same effect are *Luigart* v. *Lexington Turf Club, supra; Gamble* v. *Garlock, supra; Trumbull* v. *Bombard, supra; Hicks* v. *Christeson, supra; Ludy* v. *Zumwalt ,supra.*

The court below ignored the essential and fundamental nature of an option to buy which we have pointed out above and discarded the principle that an option contract conveys no estate or interest in the property and when accepted takes effect from the date of its acceptance and not from the date the option was given, though this principle is recognized in California as well as by the great weight of

authority in other jurisdictions. The court below said that under the law of California the option in this case gave the taxpayer such a right as will be protected in equity, and in support thereof cited *Gordon* v. *Dufresne,* 205 Cal. 512, and *Chapman* v. *Great Western Gypsum Co.,* 216 Cal. 420. Whether the taxpayer, as optionee, had a right which equity would protect is wholly beside the point here. The question here is whether the taxpayer had such an estate or interest in the property, prior to the exercise of the option, that it may be said it *acquired the property* at the time the option was given or prior to the exercise of the option. If the statement of the court below is taken to mean that the taxpayer, prior to the exercise of the option, was the equitable owner of the property or had an equitable estate or interest therein merely by virtue of the option, we submit that such a holding clearly is erroneous and the cases relied upon do not support such a view.

The *Gordon* v. *Dufresne* case was an action for specific performance of an option to purchase given in a lease of property. Within the time limited the lessee-optionee exercised the option, tendered the agreed purchase price and demanded a deed to the property, which was refused. The trial court held that the option agreement was without consideration and void. The Supreme Court of the State, in reversing the lower court and decreeing specific performance, held merely that the option agreement and the lease were not divisible, but formed

one document, and the covenant to pay rent and perform other acts supported the option as well as the right to occupy the premises. The decision is predicated solely on the ground that the option contained in the lease is supported by consideration, is valid, and when accepted according to its terms is enforceable. There is nothing in the decision in anywise tending to support a contention that the holder of an option to purchase property, whether or not contained in a lease, vests any estate or interest, legal or equitable, in the optionee prior to the exercise of the option.

In *Chapman* v. *Great Western Gypsum Co., supra,* the problem presented was, as stated by the court (p. 424):

> An owner of a lease containing an option to purchase the fee, mortgages the same to secure a debt. Thereafter the lessee-mortgagor assigns the lease to a third party who has full knowledge of the mortgage. The third party exercises the option and secures a conveyance of the fee. The ultimate legal question to be determined is whether or not under such circumstances the lien of the mortgage attaches to the fee in the hands of the third party or those who take with notice, from the third party.

The court expressly refrained (p. 425) from deciding whether the holder of a mere option to purchase real property acquires an interest therein and held only that, as the option contained in the lease

of real property was a covenant real running with the land and the mortgage of the lease included the option, the assignee of the lease and option took subject to the mortgage and *upon exercise of the option* by the assignee the lien of the mortgage attached to the fee. The decision apparently rests solely upon the ground that the assignee had actual knowledge of the mortgage lien and that the mortgage lien on the option could not be defeated through exercise of the option by the assignee with notice, any more than the original holder of the option could have defeated the lien by exercising the option (p. 433). That such is the basis of the decision appears also from the discussion therein of *Ludy* v. *Zumwalt, supra,* which held that an option is not such an interest in land that a recorded lien thereon is constructive notice and that the lien on the interest of the optionee who subsequently exercised the option, acquiring the fee, is inferior to the lien of the purchase-money mortgage given upon exercise of the option. The latter case was distinguished on the grounds, among others, that in the *Chapman* case there was *actual* knowledge of the mortgage lien and the controversy was between the optionee and the lienholder, whereas in the *Zumwalt* case constructive notice of the lien was asserted and the controversy was between the optionor and the lienholder. We submit that the *Chapman* case is not authority for the view that the holder of an option to purchase real property

owns an equitable interest in the property prior to the exercise of the option.

It may well be that the holder of a valid option to buy real property, supported by a valuable consideration, has rights which equity will protect by such means as requiring specific performance where the option is timely exercised according to its terms and preserving his contractual rights against subsequent purchasers with notice of the option. But such equitable rights and remedies are not founded upon any estate or interest of the optionee in the property. They arise from his rights under the option contract which gives him the ***right to buy*** and is binding on the optionor, and all who take under him with notice, when the optionee elects to exercise his right. That, manifestly, is a matter quite distinct from the question whether the option vests in the optionee any estate or interest in the property prior to exercise of the option. As we have shown, the latter question is answered in the negative.

The court below further said, in an effort to support its conclusion, that from the standpoint of the revenue laws the rights of the optionee, upon exercise of the option, should be *related back* to the date of the option and the resulting contract of sale treated as made on that date, and in support thereof cited *Smith* v. *Bangham, supra.* In that case it was held that the holder of a valid option to buy real property, upon the timely exercise of the option,

was entitled to specific performance notwithstanding the declaration of homestead by the optionor's wife made after the option contract and with actual knowledge thereof. The court held merely that the *right of the optionee to specific performance,* when exercised, necessarily related back to the date of the option *so as to cut off intervening rights acquired with knowledge of the existence of the option.* The case does not hold that an option vests an estate or interest, legal or equitable, in the optionee prior to its exercise or that upon exercise of the option the title, estate or interest then acquired relates back to the date of the option for all purposes. Indeed the court recognizes the prevailing rule that no estate or interest in the property vests by virtue of the option. The decision rests solely upon the ground that a subsequent purchaser of property with knowledge of the existence of a valid option thereon takes subject to the right of the option holder to accept the optionor's offer to sell (p. 365). And that seems to be the basis of those decisions which *appear* to hold contrary to the rule established by the weight of authority. See James on Option Contracts, Sec. 501. There are no such considerations in this case warranting the application of the doctrine of relation back. The doctrine is a mere fiction, used only to prevent patent injustice, and is generally applied to protect the optionee against intervening purchasers with notice of the rights of the optionee. When no such un-

usual circumstances exist the basis for the doctrine is removed and title to the property does not relate back. See *Lady* v. *Zumwalt, supra* (p. 129). In the absence of such circumstances, upon the exercise of the option the title and estate in the property vest at that time and the optionee takes the property in its then condition. See *Caldwell* v. *Frazier, supra.* We submit there is wholly lacking any circumstance in the present case justifying application of the doctrine of relation back. No injustice here is done by applying the usual and recognized principle that the property vests, is acquired, only when the option is exercised.

Moreover, it is submitted that this doctrine, which is sometimes applied in equity for the limited purpose noted, has no proper application in the construction and administration of the income tax laws. *Coyle* v. *Commissioner,* 17 B. T. A. 368; *City Bank Co.* v. *Commissioner,* 1 B. T. A. 210. In the *Coyle* case, the contention that the optionee who purchased an oil lease should be considered the owner of the property from the date of the option was rejected. The Board there said (pp. 379–380):

> Whatever may be the merits of this fiction when applied to the devolution of estates, it can find little, if any, place in income-tax law. Our various revenue acts make the taxable year, whether calendar or fiscal, the period for which all income must be returned and taxed. Except for the net loss provisions in the various revenue acts, the net in-

> come for the taxable year is dependent on what occurred in that year. While it is true income and losses may be accrued by one who keeps his books on that basis, yet such accruals must be based on what actually occurred in the taxable year. If we admit the fiction here asserted by respondent, we will find one returning and properly returning as rent what he received from a lease and years afterwards we will find the same person compelled to return such rentals as purchase money received. The contract we have before us runs through two taxable years and it would be quite peculiar to hold that petitioners were the owners of the lease during December, 1921, but that they were not owners of the lease from that time on to the time of execution of the option. The contention made by respondent is based entirely upon a fiction. Tax laws deal with realities. Taxes "are not laid upon abstractions." *Edwards* v. *Slocum,* 287 Fed. 651, affd., 264 U. S. 61. We find no merit in this contention.

The *City Bank Co.* case involved a purchase of land by the mortgagee under a judicial sale decreed in September, 1912. The sale made pursuant to the order or decree was not confirmed and the deed was not delivered until March 24, 1913. Holding that the land was *acquired,* within the meaning of the revenue Act, after March 1, 1913, the Board said (pp. 212–213):

> There is another rule of law with respect to judicial sales to the effect that upon con-

firmation thereof the deed executed pursuant thereto takes effect by relation as of the day of sale, and vests in the purchaser the right to intermediate rents (16 Ruling Case Law, 132; *Jashenosky* v. *Volrath,* 59 Oh. St. 540).

The taxpayer having title by relation as of February 28, 1913, the day of sale, the question is, does title by relation meet the requirements of the statute that the property must have been *acquired* before March 1, 1913, in order that the fair market price or value as of that date may be used as the basis for determining gain or loss on the subsequent sales. The word *acquired* was undoubtedly used in the statute in its ordinary sense of "obtained as one's own" and we think it should be applied in that sense. On March 1, 1913, the taxpayer had no title and could have none until the sale was confirmed by the court. Upon confirmation and the execution and delivery of the deed it had title by relation as of February 28, 1913, but we do not think title by relation as of a particular date is equivalent to having acquired the property on that date. The property was not "obtained as its own" prior to March 1, 1913, but only from the date of confirmation, and the fact that upon confirmation the title relates back to the sale does not meet the challenge of the statute.

The principle that an option to buy property confers or vests no estate or interest in the property prior to exercise of the option, is equally well recog-

nized in applying the revenue acts as in other fields of law. In *Lucas* v. *North Texas Co.*, 281 U. S. 11, the taxpayer in 1916 gave an option to purchase certain land, and was notified in the same year that the option would be exercised. The transaction was not completed until 1917, when payment was made and the land conveyed. This Court said (p. 13):

> An executory contract of sale was created by the option and notice, December 30, 1916. In the notice the purchaser declared itself ready to close the transaction and pay the purchase price "as soon as the papers were prepared." Respondent did not prepare the papers necessary to effect the transfer or make tender of title or possession or demand the purchase price in 1916. The title and right of possession remained in it until the transaction was closed. Consequently unconditional liability of vendee for the purchase price was not created in that year.

It was held that the profit on the sale was income in the year 1917. If the profit on the sale of land under an exercised option to buy is not income to the vendor until the transaction is completed, it would seem, conversely, that the vendee does not acquire the land or any interest therein at least until the option is exercised.

In *Commissioner* v. *Cummings*, 77 F. (2d) 670 (C. C. A. 5th), the taxpayer exercised his option to buy certain stock and claimed that the gain on a

sale of the stock should be taxed at capital gain rates, since the option was acquired more than two years prior to the sale, although the stock itself was acquired less than two years before the sale. The statute defined capital assets, on the sale of which gains are allowed a special tax rate, as property held for more than two years. The court held that the stock was held only from the date the option was exercised and not from the date the option was acquired. It was said (pp. 672–673):

> The shares thus acquired came to the taxpayer as new property. * * * They may not be considered as standing for the options upon the exercise of which they were purchased, and therefore as held for more than two years prior to their exchange and sale.

In *Chisholm* v. *Commissioner,* 79 F. (2d) 14 (C. C. A. 2d),[3] the taxpayer and his brother, owning certain stock, gave to another an option to buy, to be exercised by payment of cash within the time specified. Prior to due exercise of the option, but after notice that it would be taken up, the brothers formed a partnership and transferred the stock to it. The option was exercised and sale completed.

[3] The Government filed with this Court a petition for certiorari, No. 519, to review that case, which was denied November 11, 1935. The contention there urged by the Government was that under the particular circumstances presented the gain derived from the sale of the stock was taxable income to the individuals because the sale in reality was made by the individuals, the firm acting merely as their agent.

In holding that the sale was made by the partnership, not by the individuals, and that the sale was not made until the option was exercised, the court said (p. 15)—

> the option was an offer to sell, not to contract to sell; it required payment, not a promise to pay, and the notice, not corresponding with the offer, was legally a nullity. The sellers became bound only * * * when Krauss & Co.'s assignees paid the price.

Underlying each of these cases is the principle that the holder of an option to buy, prior to the exercise thereof, acquires no title or interest or estate in the property itself. On that basis the *North Texas Co.* case held that full ownership of the land remained in the vendor until 1917 and hence the gain was taxable income for that year, and not for 1916 when the option was given, although notice of acceptance was given by the optionee in 1916. Similarly, the *Cummings* case ruled that the property sold had not been held for more than two years, because it was not *acquired* until the option to buy was exercised. Likewise, the *Chisholm* case held that the stock was sold and passed to the optionee-purchaser from the partnership and not from the partners as individuals, because the option was not exercised until after the stock had been transferred to the firm.

In the instant case the taxpayer in 1906 took a lease upon the real estate in question, whereby it

was given the option to buy the property at an agreed price, *upon termination of the lease.* Pursuant to the lease the taxpayer proceeded to improve the property and spent substantial amounts in so doing. *Upon termination of the lease,* the taxpayer exercised the option, paid the agreed price and received the title in fee.

In the light of what has been said above, we think it plain that the taxpayer did not *acquire* the property here involved until 1916, when the option was exercised. Prior to that time it had only a right to buy and owned no interest or estate in the property, other than the term for years under the lease. Indeed, even if it might be assumed that the taxpayer prior to exercise of the option had some estate or interest in the property, such interest certainly was of no greater dignity than a contingent—as contrasted with a vested—estate. It is quite generally recognized that the holder of a contingent estate in property does not acquire the same within the meaning of the revenue acts until the estate becomes vested. See *Hopkins* v. *Commissioner,* 69 F. (2d) 11 (C. C. A. 7th); *Roebling* v. *Commissioner,* 78 F. (2d) 444 (C. C. A. 3d); *Warner* v. *Commissioner,* 72 F. (2d) 225 (C. C. A. 2d); *Pringle* v. *Commissioner,* 64 F. (2d) 863 (C .C. A. 9th), and *Lane* v. *Corwin,* 63 F. (2d) 767 (C. C. A. 2d). Cf. also, *Brewster* v. *Gage,* 280 U. S. 327. In this case no interest in the property vested in the taxpayer at the time the option was

given or at any time prior to the exercise of the option. The optionor here did not hold the property prior to the exercise of the option for the benefit of the taxpayer, as the executor in the *Brewster* case was said to have held the decedent's estate for the benefit of the legatees, heirs, and devisees and not in his own right and behalf. Prior to exercise of the option unconditional ownership of the property was in the optionor, who held in its own right and for its own benefit.

The court below felt that, as Congress did not intend to tax gains accruing prior to March 1, 1913, and to avoid grave doubts as to the constitutional power of Congress to tax such gains, it was necessary to treat the property as having been acquired when the option was obtained. We submit that there is no occasion to consider here the general question of the constitutional power of Congress to tax gains accrued prior to the adoption of the Sixteenth Amendment. While it may be true that the amount realized by the taxpayer embraces, and resulted in large part from, the enhancement in value of the property during the years prior to 1913, the fact remains that the gain accruing through such enhancement did not accrue to property owned by this taxpayer. The land and the gain accruing thereto prior to March 1, 1913, did not become the property of this taxpayer until the option was exercised in 1916. The revenue acts do not purport to

tax as gains mere accretions to the value of property which have not been severed from the capital investment therein, but it is equally plain that the statutes do tax such gains when they are severed as income of the year in which severed and received. The amount received by the taxpayer in excess of the cost of the property to it is the actual gain derived and the tax thereon places no unjust burden upon it merely because the amount of the gain may be large. It can not now be contended that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property. *Taft* v. *Bowers,* 278 U. S. 470. We submit that the decision below in effect sustains the contention which this Court said in the *Taft* case finds no support in the Constitution.

It seems clear that the taxpayer acquired the property here in question in 1916, when the option was exercised, and the purchase price was paid according to its terms, and the property was delivered to it. It follows necessarily that under the statutes the basis for determining the taxable gain on sales of the property is the cost thereof to the taxpayer, and the Circuit Court of Appeals erred in holding that the proper basis is the March 1, 1913, value of the property.

CONCLUSION

The decision of the Circuit Court of Appeals is erroneous and should be reversed.

Respectfully submitted.

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